Senior European Experts

# The Eurozone: Recent Developments

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## Introduction

In a previous paper, the Senior European Experts examined various facets of the financial crisis in Europe that threatened the continued existence of the eurozone.[1] By 2013, the eurozone's position had improved enough for the then President of the European Council, Herman van Rompuy, to remark that the existential threat had passed.[2]

However, low or stagnant growth, unemployment (amongst young people in particular) and growing tensions over inequality have continued to hamper the eurozone economy, which is now showing signs of deflation (eurozone inflation currently stands at approximately minus 0.3 per cent, an improvement from January 2015, but is predicted to fall further).[3] New elements of volatility have emerged in the last 12 months, including: instability in Ukraine caused by Russia's annexation of Crimea and EU sanctions against Russia in response; the sudden, sharp drop in the price of oil; and the election of a left wing anti-austerity government in Greece.

This briefing paper focuses on two of the most prominent responses to these issues – the further development of European fiscal and banking union and the European Central Bank's decision to expand its bond-buying programme – in the context of wider political developments.

## Background

The problems of limited investment and poor economic growth in the eurozone are caused by a number of factors, including the effects of debt reduction programmes in several member countries, the low levels of consumer confidence (and therefore spending) in others, and the absence of necessary structural reforms. The lack of competition in several eurozone countries has limited their ability to take advantage of the recovery underway in other parts of the world, such as the UK, the USA and, more recently, Germany.

Stagnating wages and high unemployment follow from this economic situation. In the eurozone, approximately 18.1 million people are unemployed and close to 20 per cent of those are young people; Greece and Spain have the highest levels of unemployment – 25.8 and 23.7 per cent, respectively – putting them well above the eurozone average of 11.4 per cent. Italy and Portugal fare slightly better with unemployment rates of 12.9 and 13.4 per

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[1] See Senior European Experts, *The Eurozone Crisis: An Update*, March 2012

[2] Herman van Rompuy, *'Europe in the World': Lecture at Regent's University*, 18 September 2013

[3] Trading Economics, 'Euro Area Inflation Rate Forecast', 5 March 2015

 

cent, respectively, and Ireland even more so where unemployment has dropped to 10.5 per cent.[4] However, there has recently been a sharp upturn in growth in Ireland and Spain.

The European Central Bank's (ECB) recent stress tests of banks across Europe found that one in five banks has too little capital to withstand another financial crisis.[5] Results like these have made investors cautious and reduced the ability of business to expand. Continuing concern about the stability of financial institutions has been an aggravating factor and the drop in oil prices, though good for consumers, has also worried investors.

Cross-border lending in the eurozone – both inter-bank and consumer lending – has slowed significantly since the beginning of the financial crisis. The total number of loans made between eurozone banks was down to less than one per cent in 2014.[6] Banks in the periphery countries of the eurozone – Greece, Ireland, Italy, Portugal and Spain – are in the worst position since they not only have to contend with limited cross-border lending but also difficulty in accessing wholesale finance. For the citizens of these countries, this makes it increasingly difficult to access household finance, mortgages and credit for opening and running businesses.

For the eurozone as a whole, the reduction in cross-border lending is of major concern because it threatens to lead into even more serious economic problems: beginning with the disintegration of financial markets and the divergence in financing costs between central and periphery eurozone countries, leading to the distortion of competition within and between these countries, which hinders economic recovery throughout the euro area.[7]

## Reviving eurozone growth and investment

Investment in the EU has dropped by approximately 15 per cent from its peak in 2007; in periphery eurozone countries, the decline has been even greater, where there has been an average reduction of 40.4 per cent in investment.[8]

In December 2014, the European Council endorsed the European Commission's Investment Plan for tackling this problem.[9] The Plan aims to mobilise €315 billion in additional investment through a new European Fund for Strategic Investments (EFSI); target projects that ensure extra investment reaches the real economy; and remove barriers to investment in order to increase regulatory predictability and make Europe more attractive to investors.[10]

The Commission will work with other EU institutions, such as the European Investment Bank (EIB) and the ECB, to deliver this plan over the next three years. It is intended that the Investment Plan will be rolled out later this year but the EIB has already made EFSI pre-financing available for small and medium-sized enterprise (SME) projects across Europe.[11]

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[4] Eurostat, 'Unemployment statistics', December 2014

[5] See European Central Bank, *Aggregate Report on the Comprehensive Assessment*, 26 October 2014

[6] Bank for International Settlements, *BIS international banking statistics at end-September 2014*, 20 January 2015, p. 2

[7] Sebastian Dullien, *How to complete Europe's banking union*, European Council on Foreign Relations, 28 July 2014, p. 6

[8] European Commission, *An Investment Plan for Europe*, 26 November 2014, p. 4

[9] European Council, *European Conclusions – 18 December 2014*, 18 December 2014, pp. 1-3

[10] European Commission, *supra* n. 8, p. 4

[11] European Investment Bank, *'Europe*'s Finance Ministers endorse EIB Group engagement in Juncker plan as EU Bank announces early delivery on lending targets', 17 February 2015

On 22 January 2015, the ECB announced its own plan for reviving growth. The ECB will buy up government debt throughout the eurozone in an important monetary policy intervention known as quantitative easing (QE). This involves the creation of money by central banks that they then use to buy debt from smaller financial institutions in order to increase liquidity in the economy, keep interest rates low and encourage lending between retail banks and consumers. The ECB intends to create enough money to buy €60 billion of government debt each month until at least September 2016 in order to stabilise prices and ensure that inflation is close to the optimal just below two per cent level.[12] QE has already been tried with some success in Japan, the UK and the USA; evidence from the Bank of England suggests that its QE programme increased GDP in the UK by three per cent.[13]

QE has already had a positive impact on the eurozone economy by lowering the value of the euro, which has boosted exports and improved market confidence, thus tackling deflation; the mere prospect of a QE stimulus caused the value of the euro to drop to its lowest level against the US dollar in ten years. Coupled with the limited investment options available in the eurozone, and the possibility of the Federal Reserve raising US interest rates, QE is likely to continue to weaken the euro exchange rate, which should continue to stimulate eurozone exports and increase employment.

The long-term effectiveness of QE is not certain; compared to other economies, the eurozone is implementing QE at a much later stage of the economic cycle. QE was effective in the UK and the USA because it was introduced when borrowing costs were high but QE is being implemented in the eurozone at a time when borrowing costs are historically low.

Critics see QE as a short term and unsustainable solution to a long term problem. In their view, the initial economic boost that QE gives risks distracting from necessary reform, which will be harmful in the long run. Further, the short term nature of QE could mean it is dismissed by major investors who prefer to make longer term investments.

The eurozone's limited use of capital markets is another factor to be considered. QE was effective in the UK and USA because capital markets are utilised extensively in these countries whereas the eurozone depends almost entirely on finance from banks. The eurozone's failure to make more use of capital markets means money injected by QE into the economy could fail to filter down to where it will have a directly beneficial effect on the level of investment.[14]

## Eurozone governance and competitiveness

Germany was for long a vocal opponent of QE. The Bundesbank has been particularly outspoken in its opposition to QE because it believes that making an economy more competitive and efficient is the pre-condition to reviving it. Expanding the supply of money, the Bundesbank argues, dramatically reduces the incentives for governments to do this. In its view, QE disrupts and distracts from the necessary structural reforms that would allow struggling eurozone

[12] European Central Bank, 'ECB announces expanded asset purchase programme', 22 January 2015

[13] Martin Weale & Tomasz Wieladek, *What are the macroeconomic effects of asset purchases?*, Bank of England External MPC Unit Discussion Paper No. 42, 1 April 2014, p. 35

[14] Raoul Ruparel, *Quantitative Easing in the Eurozone: limited economic benefits at a high legal and political cost*, Open Europe, 19 January 2015, pp. 8-10

countries to become more competitive and therefore improve economically. The Chancellor of Germany, Angela Merkel, also resisted QE because of the risk it posed to taxpayers in being burdened with the potentially heavy losses of defaulting eurozone countries.

In response to these concerns, the President of the European Central Bank (ECB), Mario Draghi, announced that only 20 per cent of asset purchases would be subject to eurozone risk sharing. Usually risk is shared across the 19 national central banks (NCBs) of the eurozone relative to the size of their economies. However, this decision to avoid risk sharing means that each of the NCBs will be largely responsible for buying the bonds of their own countries and will be solely responsible for any losses. This is good for those NCBs and countries with safer bonds, like the Bundesbank and Germany, but puts less stable eurozone economies in a potentially vulnerable position since 80 per cent of the bonds purchased will remain on national balance sheets.[15]

This decision to avoid risk sharing in the eurozone marks a significant departure from ECB precedent. Political pressure, especially from Germany, has forced the ECB to abandon risk sharing, a fundamental eurozone principle, and could raise the question whether the eurozone is a true monetary union if it fails to share liabilities and losses across all members.

While QE has altered the relationship between the ECB and eurozone countries, the construction of a banking union in Europe has also advanced considerably.[16] In November 2014, the ECB became the central supervisor of financial institutions in the euro area under the Single Supervisory Mechanism (SSM), part of the regulatory framework put in place for more effective oversight of the banking industry. The SSM exists alongside the Single Resolution Mechanism (SRM), another part of the regulatory framework, which will allow failing institutions to be restructured and financed to protect taxpayers from the burden of bailouts. With the SSM and SRM, there is now a clear basis on which banking union in the euro area can develop and this has already begun to improve confidence in the financial system.[17]

## Developments in Greece

Three days after the ECB announced its QE programme, the people of Greece went to the polls and elected a left wing government. The new Syriza-led government is committed to keeping Greece in the eurozone and approximately two-thirds of Greeks want to continue using the single currency.[18] However, the new government is fiercely anti-austerity, has rejected any continuation of the troika's (ECB, EU and International Monetary Fund) special bailout process, and is eager to renegotiate the country's debts and increase public spending. This represents a major challenge for the eurozone and has resulted in tough negotiations.

In February 2015, Greece negotiated a short-term extension to its loan from the eurozone under the Master Financial Assistance Facility Agreement (MFAFA), narrowly avoiding a default when it became apparent that the central government had a slight but significant

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[15] European Central Bank, *supra* n. 12

[16] For more detail on European banking union, see the Senior European Experts papers, *Banking Union: Proposals for Banking Regulation*, October 2012; and *Bank Recovery & Resolution: European Commission Proposals*, October 2012

[17] Sebastian Dullien, *supra* n. 7, p. 8

[18] Marcia Kramer (ed.), *A Fragile Rebound for EU Image on Eve of European Parliament Elections*, Pew Research Centre, 12 May 2014

net cash deficit.[19] Greece now has access to €240 billion until June 2015 under the MFAFA, allowing it to cushion the detrimental effects of capital flight triggered by the uncertainty surrounding the new government's policies. The ECB has also agreed that Greek banks can continue to access the Emergency Liquidity Fund and increased the amount that the banks can request from €3.3 billion to €68.3 billion.

In return, the Greek Finance Minister, Yanis Varoufakis, accepted that the extension was conditional on Greece continuing to introduce reforms attached to the loans as agreed in the Memorandum of Understanding signed by the previous Greek Government.[20] Mr. Varoufakis made clear that his government will continue to seek for the Memorandum to be renegotiated in certain aspects in order to reduce the impact of the measures on Greece. At a meeting of the Eurogroup, the organisation comprised of finance ministers representing eurozone countries, Mr. Varoufakis presented a list of reforms that included *inter alia* structural reforms relating to tax evasion, corruption and public administration but made clear (again) that the Greek Government would continue to pursue policies to reduce austerity. The Managing Director of the International Monetary Fund, Christine Lagarde, criticised the list as too broad and vague but ultimately welcomed the proposed structural reforms in the areas of tax evasion and corruption,[21] as did the European Commission, describing the reforms as "sufficiently comprehensive to be a valid starting point for a successful conclusion of the review [of the Greek bailout programme]".[22] With the progress that has been made so far in the negotiations between Greece and its creditors, the country has bought itself a short breathing space.

## Future prospects

In a speech given at the beginning of the year, the Governor of the Bank of England, Mark Carney, argued that the success of the single currency depends on the sharing of fiscal sovereignty; building risk-sharing institutions, he said, is the basis of all successful currency unions and European monetary union will not be complete until mechanisms are put in place to share responsibility for fiscal policy across the euro area.[23] This argument is similar to the thinking that resulted in the Fiscal Compact Treaty, which emphasised, amongst other things, economic policy co-ordination.[24]

The creation of an EU-wide capital markets union (CMU) – an objective which has been endorsed by the Juncker Commission – is another dimension of securing the success of the eurozone along with the EU as a whole. Given that the eurozone makes limited use of capital markets and cross-border lending is down, successfully creating a CMU in Europe would strengthen the focus on economic growth. The benefits of CMU were emphasised by the EU Commissioner for Financial Stability, Financial Services and Capital Markets Union,

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[19] *Master Financial Assistance Facility Agreement between European Financial Stability Facility, the Hellenic Republic as Beneficiary Member State, the Hellenic Financial Stability Fund as Guarantor and the Bank of Greece*, 27 November 2012

[20] *Memorandum of Understanding between the European Commission acting on behalf of the Euro Area Member States, and the Hellenic Republic*, 9 March 2012

[21] *Letter by IMF Managing Director Christine Lagarde to the President of the Euro Group on Greece*, 23 February 2015

[22] European Commission, *Letter by Vice-President Valdis Dombrovskis and Commissioner Pierre Moscovici to the President of the Eurogroup, Jeroen Dijsselbloem, on the Greek government's reform proposals*, 24 February 2015

[23] Mark Carney, *Fortune favours the bold: Speech at Iveagh House*, 28 January 2015

[24] See Senior European Experts, *The Fiscal Compact Treaty*, March 2012

Lord Hill, as part of his evidence to the House of Lords EU Economic and Financial Affairs Select Committee in February 2015.[25]

Harmonising bond markets and the securitisation industry will make cross-border investment in Europe much easier and will allow eurozone countries to make more effective use of capital markets to raise funds for their flagging economies. It will also increase the effectiveness of the ECB's QE policy, as discussed above. While City opinion on CMU is generally positive, Lord Hill warned that harmonising tax laws but not tax rates, needed to ease capital movements, carries political implications. This suggests that the formation of a European CMU will require significant negotiation and is likely to take considerable time to establish.[26]

The creation of the EFSI, the implementation of QE in the eurozone, and the first steps towards forming a CMU in Europe are all positive moves towards creating an environment for economic recovery in the eurozone. Whether these will significantly reduce unemployment and stagnating wages more widely remains to be seen. The situation in Greece will continue to be a problem for the foreseeable future.

So far the response of the eurozone countries to the financial crisis has tended to be late and half-hearted. They have become divided over austerity, with some implementing successfully (if painfully) the necessary measures (Cyprus, Ireland, Portugal and Spain) but with others objecting to such policies and, to varying degrees, resisting them (France, Greece and Italy). The political unpopularity of austerity measures has created a new domestic political dynamic in several eurozone countries, not just in Greece, which threatens to undermine the eurozone's hard-won stability.

***March 2015***

[25] House of Lords, *Unrevised transcript of evidence taken before The Select Committee on the European Union Sub-Committee A (Economic and Financial Affairs) Inquiry on Capital Markets Union*, 3 February 2015, p. 4

[26] *Ibid.*

# Senior European Experts

The Senior European Experts Group is an independent body consisting of former high-ranking British diplomats and civil servants, including several former UK ambassadors to the EU, and former officials of the institutions of the EU.

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